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Financial Services Industry Study Paper

Seminar 16

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Introduction

The National Security Strategy of the United States cites sustained economic growth and prosperity as a vital national objective. Key to economic growth and prosperity is a healthy financial services sector. History shows that a weak financial sector can exacerbate economic downturns. Weaknesses in the US banking system greatly aggravated the United States' difficulties during the Great Depression. Other historical examples include Mexico, Russia, Argentina, and Japan; in all cases, weak financial systems have contributed significantly to economic problems and overall loss of influence on the world stage. Therefore, assessing the health of the financial services industry is an important step in assuring continued U.S. national power, prosperity, influence, and security.

The research supporting this paper included individual examination of key issues facing the industry by the 16 seminar members as well as field research in Washington, D.C., New York, Chicago, Hong Kong, and Tokyo. The seminar visited financial institutions that make up the industry, governmental, quasi-governmental, other regulatory agencies, and financial industry associations in order to get a complete picture of the complicated, highly interconnected structure of the industry.

The paper begins by describing the basic components and health of the financial services industry. It continues with a discussion of the major challenges facing the industry, what role the government plays in the industry, and the outlook for the future. Short essays addressing the most pressing issues facing the industry, both domestically and internationally, precede an overall conclusion.

Financial Services Industry Defined

The financial services industry exists to bring savers, investors, and borrowers together using the process known as financial intermediation. There are many “pieces and parts” required to make the industry function efficiently and effectively. Five major business segments make up the financial services industry: the capital markets (including equities and fixed income trading, commodities and currencies trading, and investment banking); retail and commercial banking; insurance (life, property, and casualty); mortgages; and payment services. The industry extends beyond the businesses to government regulatory agencies such as the Federal Reserve, the Securities and Exchange Commission, the Commodities and Futures Trading Commission; quasi-governmental agencies such as Fannie Mae and Freddie Mac. It also includes industry associations such as the American Council of Certified Public Accountants, the American Banking Association, the American Council of Life Insurers, and the Credit Union National Association. This list is not comprehensive, but is indicative of a complex mix of public oversight and private initiative that evolved over time, is not easily be duplicated, and remains vulnerable to excesses and imbalances. All of these institutions must consistently and vigilantly work together to provide the checks and balances necessary for a healthy financial services industry.

Two trends are currently shaping the financial services industry. First, globalization of operations and the tighter coupling of financial markets through advanced telecommunications and information technologies are increasing the interdependence of the US industry with its global partners. Whatever affects the financial services industry of other countries may affect the US as well. Second, global financial markets are becoming increasingly competitive as markets integrate. Profitable business niches are becoming harder to find and profit margins are

getting narrower. How financial institutions and regulating agencies respond to these changes will continue to shape and define the financial services industry.

Current Condition of the Financial Services Industry

The United States has the most efficient, transparent, and well-capitalized markets in the world. The large volume of foreign direct investment pouring into the United States reflects a high degree of confidence in U.S. financial markets on a global scale. The September 11th terrorist attacks, which dealt a direct blow to the financial services industry, barely caused the markets to miss a beat. This resilience is due in part to three factors that, over the past decade, have combined to significantly strengthen the industry. Those factors are deregulation, financial product innovation, and information technology.

Deregulation. The Gramm-Leach-Bliley Act, passed in November 1999, facilitated the development of diversified financial institutions. This allows the market system to decide what arrangements are viable. It also established a supervisory structure for balancing the difficult tradeoffs that arise when firms subject to different types of regulation are combined into one entity. The basic problem was how to allow banks and other financial institutions to respond to the evolving marketplace, and, at the same time, preserve the benefits of the financial safety net provided to banks without extending it to other financial activities, which could potentially create moral hazard. Gramm-Leach-Bliley requires some separation of financial activities into different subsidiaries of a common parent, the financial holding company. Under this approach, the usual regulators continue to play their roles for a particular type of legal entity, but an umbrella supervisor (the Federal Reserve) focuses on protecting the insured and regulated depository subsidiaries of the financial holding company. In the three years since the passage of Gramm-Leach-Bliley, nearly 600 financial holding companies (FHCs) have been formed.¹

Financial Product Innovation. New financial products disperse risk more effectively to those willing and able to bear it. Shocks to the overall economic system are accordingly less likely to create cascading credit failure. Lenders have the opportunity to diversify, and borrowers are far less dependent on specific institutions for funds. A major contributor to dispersing risk is the wide-ranging development of markets in securitized commercial and residential mortgages, bank loans, and credit card receivables. Especially important is the flexibility and size of the secondary mortgage market. The extensive use of interest rate swaps and options to hedge maturity mismatches and prepayment risk enhances this market's flexibility.

Financial derivatives grew at a phenomenal rate over the past few years. Advances in pricing options and improvements in computer and telecommunications capability significantly lowered the costs of operations and expanded opportunities for hedging risks not readily managed in earlier decades. These products contributed to the development of a more flexible and efficient financial system, both domestically and internationally.²

Information Technology. The financial services industry was the first major US industry to embrace information technology and today represents the state of the art. Three areas in the financial services industry have profoundly benefited from incorporating information technology: operating costs, contact management, and customer service.

The primary reason the financial services industry sought out information technology was to reduce operating costs. Studies on processing costs revealed that it cost about one cent to conduct transactions via the Internet versus one dollar via a teller. Electronic security exchanges and electronic bill paying are two examples of increased efficiency due to the application of information technology.

In the area of contact management, information technology has revolutionized the ability of banks, broker-dealers and insurance companies to reach their current, new and perspective customers. The cost of attracting and retaining customers is dramatically reduced via the Internet, on-line tools, and mobile technology once the necessary architecture is in place.

Computers and telecommunications technology improve customer service by enabling financial institutions to offer a greater array of products and services at extremely affordable prices. Businesses can interact with their customers on a very individualized basis. Businesses not only compete on product pricing, but on the variety of products and the modes of interaction available for the customer. This competitive pressure keeps the larger institutions investing in more information technology and creating additional products for their customers.

Several recent technological developments afford exciting opportunities to improve customer service and provide an increased array of services. Banks are looking into new activities such as check imaging, document management systems, and Internet bill presentation and payment for companies. The securities industry is looking at more automation at the exchanges and more Internet utilization for trading. On-line trading, combined with the use of the Internet as a platform for financial information, has enormous growth potential. In addition, the switch to electronic trading for interbank spot foreign exchange transactions has markedly reduced the trading volumes required to maintain an effective market, and various types of electronic communication and trading systems have been developed to streamline over-the-counter derivative transactions. The impact for the consumer and the industry is obvious and immediate – cheaper and faster transactions.

Challenges

Although an effective combination of deregulation, financial innovation, and information technology applications has considerably strengthened the financial services industry, a number of challenges may hurt the health of the industry and our economy in the future if ignored. Key challenges include transparency, reinsurance, infrastructure protection, and human resources issues.

Transparency. Expanded powers and business opportunities given to financial institutions by law and regulation have increased the size and variety of operations within leading financial organizations. The pace of financial innovation is accelerating considerably. The 21st Century will see financial firms offer, and businesses use, almost limitless configurations of products and services and sophisticated financial structures. A byproduct of these developments will be that outsiders have more difficulty understanding the positions of financial organizations, and snapshot financial reporting will be less meaningful. Transparency requires that as these practices advance, so must the approaches used by firms to disclose their financial condition and performance as well as their risk profile and risk management activities.³ The “Short Essays” section at the end of this paper features an essay that delves more deeply into the transparency issue and makes recommendations for stemming the negative trends seen recently in this area.

Reinsurance. Another challenge to the financial services industry is the post-September 11th problem with insurance companies refusing to provide reinsurance for acts of terrorism. Reinsurance is a transaction in which one insurer agrees, for a premium, to indemnify another insurer against all or part of the loss that the insurer may sustain under its policies of insurance. Reinsurance enhances the fundamental objective of insurance: to spread the risk so that no

single entity finds itself saddled with a financial burden beyond its ability to pay.

Before the September 11th terrorist attacks, insured losses resulting from terrorism in the United States were extremely infrequent. Insurance companies considered the risk so low they did not identify or price potential loss from terrorist activity separately from the general property and liability coverage provided to businesses.⁴ Inadequate data exists since the terrorist attacks to estimate the frequency and magnitude of future terrorism losses. Therefore, insurance companies do not know how to price the risk and are withdrawing from the market.⁵ The withdrawal is happening more quickly among reinsurers because US regulatory and legal constraints impact them less.

Some industry observers believe private markets will eventually develop and expand the capital available for terrorism insurance coverage and develop risk-spreading mechanisms, but whether or how quickly is not yet evident. In the interim, the Terrorism Risk Protection Act (H.R. 3210) was passed in the House and is pending in the Senate.⁶ The Bill charters the Homeland Security Mutual Reinsurance Company to assume reinsurance of terrorism risk.

Infrastructure Protection. The same forces of technology and globalization that are revolutionizing the financial services industry are creating new challenges for those entrusted with protecting financial institutions against crime. Security officials are developing strategies within the industry and with governments and law-enforcement agencies at the national and international levels to stay ahead of criminals who target financial institutions. The challenge is to recognize vulnerabilities, identify the various entities that seek to exploit them, and to develop countermeasures. Security efforts must focus on risk management because unidentified vulnerabilities and unidentified threats will always exist. Another challenge is to establish coordination between government and industry to achieve and maintain effective protective

measures. The Federal government must be cautious not to over-mandate. Industry must demonstrate the capability to develop adequate protective measures voluntarily. The industry must embrace business practices that promote information sharing among firms regarding vulnerabilities, threats, and protection. As world economies continue to integrate, protection of the US financial services industry infrastructure may ultimately require a global security system.

Human Resources. Skilled workers are vital to sustaining the growth of the financial services industry, particularly in an environment of constantly changing regulation, the development of information technology, and the demands of increasingly sophisticated customers. The expansion of financial products and services creates a demand for workers who possess advanced skills. A bank teller who has spent years providing customer service face-to-face may not be immediately capable of taking on the duties of a call center. Management must make an investment in training as it adopts new products and services. For some institutions, this extra investment may put pressure on already thin profit margins.

Some financial institutions choose to retain and train their workers to use information technology more effectively, believing the firm's investments in both information technology and employee training will improve profits in the long run by attracting new customers through its better service and products. Others choose to pay for technology with the idea that it will replace workers, realizing near term profits by offsetting information technology purchases with the reduced costs for human resources. Information technology may allow firms to reduce their workforce through efficiencies gained with centralized call-centers and networked databases, but more likely the technology will increase the need for skilled workers to solve a new set of problems resulting from greater use of technology and new products and services.

Outlook

If regulators, financial intermediaries, and corporations work in concert to resolve the challenges discussed above in a timely and constructive manner, they will strengthen an already robust industry. As it stands today, the financial services industry is fully capable of supporting national security resource requirements. US investment firms are the most market oriented, innovative and competitive in the world at bringing together those having capital and those needing capital. In addition, the rule of law and established property rights in the United States lend stability to our markets and draw capital from around the world. These factors favor the continued health and preeminence of this industry as globalization accelerates.

While our financial industry can compete globally for capital, the recent Enron scandal and the events of September 11, 2001 cast clouds over the next five years. First, Enron has shaken investor confidence in our markets and corporate governance. The government and the entire financial industry are working to address the accounting and governance issues to ensure that all investors have relevant, accurate and timely information. How we handle these issues will dictate the long-term success of the industry and our economy. Second, while the financial industry was able to continue operations in spite of the September 11th terrorist attacks, the system was “stressed.” In the days following the attack, the financial system required a major injection of funds by the Federal Reserve. As a result of the governmental intervention, the public retained their faith in the economy. Another attack on the financial system, however, might yet undermine investor confidence, with capital flowing out of our markets. The industry, along with the government, is devoting a tremendous amount of resources to the security issues of September 11th and general infrastructure protection to help sustain confidence levels.

Long-term concerns involve the continued current account deficit and the coming shortfalls in Social Security. The United States depends upon foreign entities to reinvest this deficit in the United States. If our markets are no longer attractive, we will no longer have this capital available. As for Social Security, the coming decades will see the number of retirees soar as the number of workers drops. The government must either decrease benefits or increase taxes to ensure the solvency of Social Security.

Government Roles and Goals

The financial services industry is characterized by an extensive government regulatory presence. The key challenge to government regulatory agencies, as well as to Congress, is maintaining the right balance between regulation and market forces. Situations continue to arise that challenge this balance, and involve the government in myriad ways. For example, with the passage of Gramm-Leach-Bliley, changes in the way firms deliver financial services to their customers and in the nature of the relationship among providers of various financial services may require some adjustments in the implementation of antitrust policy.⁷ In particular, as the number of large, geographically diverse banking organizations increases, the nature of competition among banks within a local geographic market may change. Likewise, if financial institutions continue to expand the scope of products offered within a single organization, the influence of non-bank competitors on prices of services provided by banking organizations may increase. The government must monitor and analyze the effects of these and other developments on the nature of competition within the financial services industry, and must be prepared to make required modifications to the way competitive effects of mergers and acquisitions are evaluated.

Regulatory agencies will also need to monitor the impact of the USA PATRIOT Act on the financial services industry. This act was enacted very rapidly in the aftermath of September

11th with a noted absence of debate. The impact on all areas of the financial services industry is significant, and certain aspects of the act, such as the requirement to carry due diligence beyond the first or second tier of customer relationships, that go beyond what the financial industry can implement easily may require reconsideration in the future. The Treasury, Federal Reserve, and Security Exchange Commission, among others, should collaborate with industry in a number of ways. First, to assist with increased due diligence, they should develop and provide to financial institutions education materials that address patterns of terrorist financing. There may be indicators of terrorist-related money laundering that are distinguishable from activities involving corruption and drugs. Second, the multiple databases and algorithms that currently exist should be consolidated and made available to financial institutions to share information and best practices. Third, with the Fed taking the lead, there needs to be an effort to ensure that bank examination criteria are modified to reflect the new requirements and communicate the new criteria to the banks and brokers. Fourth, the financial industry should have a part in developing regulation to enforce the law to ensure operational difficulties of implementing the act are considered and minimized. Finally, it is essential that the public debate take place, even though it is now law, and to ensure that the law is enforced as evenly as possible to make certain no one business area suffers disproportionately. These initiatives will simultaneously minimize the impact of the PATRIOT Act on the financial services industry and allow it to contribute significantly to winning the war on terrorism.

The government will also play a leading role in determining how to resolve the reinsurance problem discussed earlier. The options are to set up a government-sponsored reinsurance agency or pass legislation that forces reinsurance businesses to stay in the game. Congress is currently debating this issue.

The government may yet need to step in where infrastructure protection in the financial services industry is concerned. In the post-September 11th environment, the computer networks supporting the industry represent a key center of gravity and are therefore a target for terrorists. Increasing use of the Internet for financial transactions implies additional security as well as privacy concerns. Already thin profit margins will be stretched thinner as more money is allocated to improving protection measures. So far, the industry has been left to regulate itself in these areas, and that may be the most efficient approach. It remains to be seen whether it is the most effective approach.

These are just a few examples of the role government plays in the domestic industry. There are also international governmental roles, a key one being reform of the 1988 Basel Accord. The Federal Reserve represents the United States in this process and has been promoting reform efforts to develop capital adequacy standards that are more risk-sensitive and build upon the internal risk-rating and risk-measurement systems that have been developed by the world's most financially sophisticated and complex banks.⁸ The goal is to develop a framework that provides appropriate incentives to banking organizations to maintain strong capital positions and sound risk-management systems. The history of the 1990s, which includes episodes of global financial instability spreading from small countries through international capital markets and banks, underscores the need to maintain adequate capital in internationally active banks. This will continue to be true in the 21st century, as the effects of globalization increase.

Essays on Major Issues

Accounting and Transparency

One of the reasons the United States has the most efficient financial markets in the world

is due to its high standards of financial accounting and disclosure, or transparency. However, the Enron debacle and other recent examples of substantially overstated earnings have thrown this premier status into question and shaken investor confidence. The problem derives in part from Wall Street's focus on quarterly earnings. This short-term focus on net income can lead to wild swings in stock prices. Because many corporate compensation packages are tied to stock prices, strong incentive exists to stretch the rules of accounting. Compounding the problem is a "tone at the top" that further focuses efforts on meeting short-term profit expectations. To a large extent, the accounting profession and the standard setting process are partners in this problem. When pressing issues were brought to the FASB in the past, the focus was on compliance with technical accounting requirements rather than economic reality. The accounting profession and the SEC must refocus standard setting to reflect the needs of investors and creditors rather than just corporate management. In addition, accounting standards have failed to keep up with the sophistication of today's business. Traditional accounting standards focused on fixed financial assets of large industrial companies. The assets of an industrial firm consisted of plant, property and equipment that changed in value slowly, if at all. Now the most important assets of a company may be intangible. Accounting standards must reflect this new reality and find ways to value intangible assets.

Many different groups are undertaking initiatives to correct the problems that have recently been identified. For example, the US Financial Accounting Standards Board and the International Accounting Standards Board are considering how to improve standards for consolidated financial statements to achieve greater transparency of business exposures to special purpose vehicles and other unconsolidated entities. The SEC has issued recommendations that focus on disclosures regarding liquidity and capital resources, including

off-balance-sheet arrangements. The accounting profession has announced initiatives to curb external auditors of publicly traded companies from also providing internal audit and consulting services to their clients.⁹

Those who set accounting and auditing standards should continue their efforts to make information that is more meaningful available in financial statements and other reports. At the same time, the more complex nature of organizations and constantly changing services, customers, and business conditions, imply that market participants need additional types of information to make appropriate investment decisions. Leading firms have been developing comprehensive risk management processes for internal decision-making that can provide the framework for more meaningful risk disclosures. Regulators and market participants should encourage financial firms to develop these new approaches. Taken together, these measures should improve the transparency of complex firms.¹⁰

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Non-Performing Loan Crisis in Japan

One of the pillars of structural reform Prime Minister Koizumi promised to institute to revive the faltering Japanese economy is the disposal of non-performing loans (NPLs). For a variety of reasons, Japan's record of accomplishment in dealing with the NPL problem has been particularly dismal, even though most consider its resolution crucial to revitalizing the Japanese economy.

NPLs are problematic because for every bad loan there is a bad lender and a bad borrower, driving the total amount of lending down and resulting in less economic activity. In addition, bad investments crowd out potential good investments. Stunted economic growth is inevitable in a society whose financial sector is unduly burdened with loans that yield no return.

The Japanese government currently places system-wide problem loans in the \$320 billion range, which represents about 8 percent of GDP, more than double the level prevailing during the US Savings and Loan crisis of the 1980s.¹¹ Most financial analysts consider these figures quite conservative; estimates indicate an additional \$700 billion in additional loans bear watching.¹²

How has Japanese financial regulation contributed to this problem? Japan is renowned for having one of the most opaque regulatory systems of any advanced western country.¹³ Traditionally, the government, through its Ministry of Finance (MoF), tightly regulated Japan's financial system, allocating funds based on "administrative guidance" rather than the market mechanism and a clear-cut, impartial legal code.¹⁴ The level of government intervention into the financial sector was strengthened by the practice of placing retired officials from the MoF on the boards of many financial enterprises. At the same time, major bank groups have exercised considerable lobbying power over governmental officials. The result is a very strong informal institution that is relationship-based versus rule-based, and is greatly lacking in transparency.

Competition law is another problem in the financial sector. It is inadequate to address anticompetitive practices in Japan. The Japan Fair Trade Commission (JFTC) does not have the power to enter or inspect private premises or to search and seize. Their authority is less than the basic authorities of the National Tax Agency to conduct its enforcement activities. There are also many procedural impediments to enforcing anti-monopoly law. In addition, there is no system for private parties to obtain relief against anticompetitive practices through the courts.¹⁵ This regulatory environment promotes the existence of non-competitive companies that are more likely to default on loans, aggravating the NPL problem.

What should Japan do about their NPL problem? First, they should size up the full extent

of the problem in order to properly define how bad things are. Strict loan classifications, which state clearly which borrowers are OK and which aren't, must be implemented. It also means valuing a piece of real estate or other asset serving as collateral for a loan at prevailing market rates as opposed to valuation based on wishful thinking that a real estate rally is around the corner. Next, they should identify the riskiest institutions. Then, rather than injecting money into these poor performers, the Japanese government should allow them to fail when their time comes and spend the money on easing the unemployment hardships of those who lose jobs when the institutions fail. They should also force solvent but undercapitalized banks to raise equity capital from the private market. Reduction in leverage reduces excessive risk-taking by reducing moral hazard. It also reduces the domino effect of insolvency. Finally, they need to develop and implement a better system of credit risk management that functions to show the future amount of unrecoverable loans based on claimable assets. This will help in determining the proper level of reserves.

Japan needs comprehensive regulatory reform that fundamentally changes the role of government in the Japanese economy, not a mere reduction in the number of regulations bureaucrats can use to manage the economy. What is required is a transformation from a relationship-based case by case regulation to regulation by rules of general application.¹⁶ Regulatory reform is key to eliminating the NPL problem in Japan and ensuring it doesn't return. Implementation of a comprehensive and bold reform program is essential to the restoration of sustainable economic growth. Introduced rapidly, and in a transparent and predictable way, these measures can make a vital contribution to a faster recovery and help Japan play an important role in the stabilization of the world economy. Failure to implement reform is only putting off the inevitable adjustments the Japanese will eventually be forced to make, and has

negative implications for the global economy.

Japan's 12-year slump has the potential to deteriorate into a full-blown crisis, threatening global financial stability. US financial institutions should make sure they are not unduly exposed to Japanese banks and the US government should let businesses and investors know they will not be bailed out in the event of a Japanese financial crisis. Continued decline or crisis in Japan means weaker growth for all of its trading partners, the US included, through diminished exports to Japan and less foreign direct investment from Tokyo. As a generous donor nation, Japan's continued decline could also hinder progress in third world debt forgiveness. Therefore, neither the United States, nor the rest of the world should be complacent about what is happening in Japan. A properly functioning Japan is necessary for the long-term health of the world economy.

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Impact of China's Entry into the WTO

China is essentially balanced between tremendous financial success and catastrophic financial collapse. On the one hand, with an estimated annual economic growth rate of over 7 percent, a GDP of almost \$1.5 trillion, and a population of 1.3 billion, China is poised to burst on the global economic stage. Its two greatest economic resources are cheap labor and huge consumer demand, both of which point to tremendous investment opportunity. On the other hand, China is plagued by non-performing loans that state-owned banks have made to state-owned industries. China's slowness in resolving these loans by selling or charging off this debt is a great burden on the economy and jeopardizes economic growth.

Further complicating China's financial services industry is the fragmented way in which the government functions. A multitude of provincial governments operate in a completely unsynchronized manner and the central government is very weak. This fragmentation results in

ineffective rule of law, non-transparent business practices, and a general lack of financial standards that greatly complicates financial transactions. In addition, corruption is a constant problem. The weak central government allows the provincial governments to control and dictate economic activity within their areas without regard to other areas. Local political influence dominates the financial sector and affects financial transactions including everything from bank loans to tax collection.

Chinese leaders consider entry into the WTO the second most important change in China's economic history since Deng Xiaoping opened the door to foreign trade. Entry into the WTO will not be smooth. China's acceptance into the WTO presents a major challenge and a major opportunity for China's financial institutions. Under their agreement with the WTO, China has five years to correct the problems discussed above. They have begun to take steps to improve their non-performing loan problem, to improve transparency, and to open their financial markets to foreign competition. No one is really sure whether the outcome will be successful or not.

The Chinese economy will suffer tremendous external shocks from foreign investors. The local state-owned enterprises (SOEs) will go through a period of protectionism as provincial leaders pass laws, but this protectionism will not last forever. Many SOEs will not survive the restructuring pressures of increased foreign involvement. Hundreds of small SOEs will be closed and replaced by four or five large companies increasing unemployment by an estimated 28 million in a country of 1.3 billion. This fact terrifies the Beijing government. In order to create a social safety net, they announced that 10 percent of the revenue raised in every new listing on China's stock exchange would go into a social security fund.¹⁷

The transition to meet WTO requirements has already begun. On March 20, 2002, Citibank was approved by the PBOC to enter into a joint venture with Xiamen International Bank. This new license will pave the way for Citibank to set up foreign currency services for Chinese clients. Citibank is only the first of many. In the long run, foreign banks will be the winners. The domestic banks, which are heavily debt-ridden, will either be absorbed into the foreign banks or they will fail. Pressure from the WTO accession will eventually be beneficial to the development of China's financial sector, enabling the sector to provide more efficient and convenient services to customers. However, the road to stability will be long and difficult. The efforts of China's provincial leaders to protect the SOEs may well lead to the complete disintegration of the Chinese economy. On a recent trip to New York City, several high level American financial experts voiced different views on investing in the Chinese banking industry. While expressing concern about potential problems in China, some of these experts seemed more concerned with the possibility of missing the opportunity to take advantage of current conditions. Others felt that while there may be some problems at the beginning, China was so big it could absorb domestic business failures without incurring a major reduction in its economy. However, they all agreed that investment in the Chinese economy required careful study and analysis. While China's immediate future appears to very unstable, in the long run the Chinese demonstrate great potential to succeed because of their willingness to learn from foreign competitors and persistently pursue reforms.¹⁸

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Conclusion

The United States financial services industry is strong and healthy and it maintains the most efficient, transparent, and well-capitalized markets in the world. The September 11th

terrorist attacks dealt a direct blow to the financial services industry, but barely caused the financial markets to miss a beat. This resilience is due in part to a combination of deregulation, financial product innovation, and information technology. However, our paper addresses a number of challenges that may potentially hurt the health of the industry if they are not adequately addressed in the near future. These key challenges include transparency (addressed as a major issue essay), reinsurance, infrastructure protection, human resources, and maintaining the right overall balance between regulation and market forces.

Good stewardship is essential for continued economic growth in the US. This is why corporate governance and the government's role is such a significant concern within the industry and was discussed at length in this paper. Government regulatory agencies, Congress and good corporate governance all play a key role in maintaining a balanced approach to managing the economy, as well as ensuring the health of an increasingly interconnected global financial services industry.

The benefits of globalization come with the risk of global economic fall-out on a nation's economy based on another nation's ills. The interdependency of the global financial markets makes problems in another nation's financial services markets issues that can directly impact US economic health. Two of the essays presented in this paper illustrate this interconnectivity by their discussion of the problems in the financial services sectors in Japan and China.

After all the visits, briefings and readings, our bottom line assessment remains that the US financial services industry is healthy and its strength is essential for future US economic growth. Continued US economic growth is the foundation for our nation to maintain an effective national security strategy and maintain its global leadership position.

Endnotes

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